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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1957

No. 306.

THE COLONY, INC., Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

REPLY BRIEF FOR PETITIONER.

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CITATIONS.

Cases:

	PAGE
Carew v. Commissioner (C. A. 6th, 1954), 215 F. 2d 58	10
Davis v. Hightower (C. A. 5th, 1956), 230 F. 2d 549	5, 8
Deakman-Wells Co. v. Commissioner (C. A. 3d, 1954), 213 F. 2d 894	5, 8
Foster's Estate v. Commissioner (C. A. 5th, 1942), 131 F. 2d 405	9
Goodenow v. Commissioner (C. A. 8th, 1956), 238 F. 2d 20	5
Ketcham v. Commissioner (C. A. 2d, 1944), 142 F. 2d 996	9
Lazarus v. United States (Ct. Cls., 1956), 142 F. Supp. 897	6
O'Bryan v. Commissioner (C. A. 9th, 1945), 148 F. 2d 456	10
Slaff v. Commissioner (C. A. 9th, 1955), 220 F. 2d 65	5, 10
Uptegrove Lumber Co. v. Commissioner (C. A. 3d, 1953), 204 F. 2d 570	5, 8, 10

Statutes:

Internal Revenue Code of 1939:	
Sec. 22(a) (26 U. S. C., 1946 Ed., Sec. 22(a))	4
Sec. 23 (26 U. S. C., 1946 Ed., Sec. 23)	2
Sec. 111(a) (26 U. S. C., 1946 Ed., Sec. 111(a))	4
Sec. 275(c) (26 U. S. C., 1946 Ed., Sec. 275(c)	1, 2, 3, 4, 5, 7, 8
Internal Revenue Code of 1954:	
Sec. 6501(e)(1)(A) (26 U. S. C., 1955 Ed., Sec. 6501(e)(1)(A))	6, 7

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REPLY BRIEF FOR THE PETITIONER.

Respondent argues that Section 275(c) of the 1939 Code is applicable in any and all cases where a taxpayer's reported gross income is understated by more than 25%. Thus, respondent would construe the statute as if it read "If the taxpayer understates the final figure in his gross income computation".

The reasons advanced by the respondent in support of his conclusion are without substance, and the conclusion reached is therefore without merit.

A. *Preliminary* (Resp. Br., pp. 11-15).

In this section of his brief, respondent argues—

(1) That Congress, in enacting Section 275(c), decided to provide for a longer period for assessing deficiencies where errors in returns adversely affecting the revenue were relatively large; and

(2) There is, accordingly, an essential correlation between its description of that error and its expression of the standard for measuring it; and,

(3) It would seem logically to follow that a taxpayer has omitted from gross income an amount properly includible therein when he has understated that amount.

The first premise in the respondent's syllogism is patently fallacious.

For one reason or another, taxpayers make (and always have made) large errors in that they overstate the amount of the deductions authorized by Section 23 of the 1939 Code. For example, many taxpayers have overstated wage deductions (such as overceiling salary payments); traveling expenses (such as a trip to Europe for part business and part personal purposes); rental payments (which, as a matter of law, are purchase price payments under conditional sales contracts); interest (thin corporation cases); and taxes, business losses, bad debts, etc. Unquestionably, the extended period of limitations of the statute may not be invoked in cases of overstated expenditures claimed as deductions from gross income, *regardless of the size of the overstatement.*

Respondent disclaims knowledge as to the reason why Congress failed to draft the statute in such language as to fully carry out the intent attributed to it by respondent (Resp. Br. 12).

Petitioner submits an answer—Congress did not, in fact, intend for Section 275(c) to provide for a longer period for assessing deficiencies because of the presence of *any* relatively large error in a tax return adversely affecting the revenue. Congress intended for the statute to apply solely to cases where a taxpayer "omits" items of receipt from his computation of gross income. To use the words of the congressional committees, the statute is only applicable where a taxpayer "leave(s) out" items, "left out", "overlooks", "fail(s) to report".

The statute is not applicable in the case of errors in the form of overstated deductions. Similarly, Congress was not concerned with errors in the form of overstated cost items in the gross income section of a return. Both are "offset" items, identical in nature, and for benefit to be derived therefrom in a tax return, both must be claimed in the return. The Internal Revenue Service is not faced with the same serious discovery problems that are present where a taxpayer "omits" items of receipt properly includible in his computation of gross income.

On the basis of its faulty major premise, respondent apparently attempts to spell out "an essential correlation between its (Congress') description of that error and its expression of the standard for measuring it." To impute to Congress such a complicated intent or

objective is to indict Congress for drafting a completely inadequate statute. Obviously Congress was not thinking in terms of elusive "correlation(s)".

Respondent's reasoning is unsound, and accordingly, his conclusion is equally unsound.

B. *The Statute and its Legislative History* (Resp. Br., pp. 15-24).

Respondent emphasizes and re-emphasizes the term "gross income", but adroitly avoids direct discussion of the verb "omits".

Respondent begins his argument by referring to Section 22(a) of the 1939 Code, which defines gross income in general as including, ". . . gains or profits and income derived from any source whatever . . ." Respondent proceeds to Section 111(a) of the 1939 Code which provides, in effect, that in computing the gain or loss from the sale or other disposition of property, the "gain" from a sale is the difference between the total sales proceeds and the cost of the property sold. Therefore, concludes respondent, only "gains" from the sale of property are properly includible in gross income, and accordingly, all understatements of "gains" are automatically omissions from gross income within the meaning of Section 275(c).

Respondent finally reached the verb "omits" through the back door.

Petitioner does not subscribe to the highly technical argument of respondent as to the all importance of the use of the term of "gross income" in Section 275(c). Nor does petitioner believe that Congress was concerned with "orthodox" concepts of gross income

and involved syllogisms. The intended coverage of the statute and the meaning of the phrase "omits from gross income" used therein is ascertainable by taking a direct approach.

The usual meaning of the verb in the phrase is "to leave out". The various congressional committee reports and the transcript of the hearing before the House Committee clearly cite examples of the types of errors that Congress believed entitled the Commissioner to an extended period for assessment. Nowhere in the legislative history can there be found indications that Congress intended for the extended statute to apply to mathematical understatements of gross income resulting solely from overstated cost figures.

With regard to his conclusion that overstatements of cost result in omissions, the respondent states as follows (Resp. Br. 18):

> "This is the plain meaning of the statute, and the pertinent committee reports hardly suggest—much less compel—a contrary construction".

Petitioner submits that the committee reports effectively speak for themselves as to the scope of Section 275(c). To petitioner, and the Courts of Appeal for the Third Circuit,[1] Ninth Circuit,[2] Fifth Circuit,[3] and Eighth Circuit,[4] the legislative history conclusively shows that Congress intended for the statute

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[1] *Uptegrove Lumber Co.* v. *Commissioner* (C. A. 3rd, 1953), 204 F. 2d 570; *Deakman-Wells Co.* v. *Commissioner* (C. A. 3rd, 1954), 213 F. 2d 894.

[2] *Slaff* v. *Commissioner* (C. A. 9th, 1955), 220 F. 2d 65.

[3] *Davis* v. *Hightower* (C. A. 5th, 1956), 230 F. 2d 549.

[4] *Goodenow* v. *Commissioner* (C. A. 8th, 1956), 238 F. 2d 20.

to mean what it says—and understatements of gross income resulting from reported overstatements are not "omissions".[5]

On page 22 of his brief respondent again argues that the committee reports make it evident that Congress intended for understatements of gross income to be considered as "omissions" from gross income. Respondent then states as follows (Resp. Br. 22):

> "There is not one reference to a 'failure to disclose' or a 'leaving out' of items of gross proceeds or gross receipts."

This statement is inaccurate. In his own brief respondent refers to the example cited in the committee reports of "a taxpayer (who) failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital". Dividends are items of receipt which are properly includible in a taxpayer's computation of gross income. The omission of such items of receipt from the computation of gross income was precisely the type of error to which the statute was addressed.

Respondent concludes his argument under this section of his brief with the assertion that Congress understood, in enacting Section 6501(e)(1)(A) of the 1954 Code, that it was making changes in the existing law, and that it was re-defining the term gross income to mean total receipts.

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[5]Also see *Lazarus* v. *United States* (Ct. Cls., 1956), 142 F. Supp. 897.

In subsection (A) of Section 6501(e)(1), entitled *General Rule* (and relating to Income Taxes), Congress re-enacted the same language contained in Section 275(c) of the 1939 Code, as follows:

> "(A) *General Rule*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment at any time within 6 years after the return was filed.[6] . . . ."

After re-enacting the substantive provisions of Section 275(c) Congress, by way of addendum, inserted the following language:

> "For purposes of this subparagraph—(subparagraph (A) above)
>
> "(i) In the case of a trade or business, the term 'gross income' means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and
>
> "(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return,

[6]Two changes, not herein material, were made when Congress re-enacted this sentence from Section 275(c). In the predecessor provision, "per cent" of in the 1954 Code was expressed as "per centum", and the period for assessment was 5 years instead of 6 years.

in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item."

Obviously the general purpose of subsection (i) was to prevent future controversies as to the applicability of the extended limitation period in "cost of goods sold" cases. Congress clearly indicated its approval of the construction of Section 275(c) enunciated in *Uptegrove Lumber Co.* v. *Commissioner* (C. A. 3rd, 1953), 204 F. 2d 570, and chose to express its approval by the language inserted as subsection (i). Likewise, Congress in adding subsection (ii), approved of the interpretation of Section 275(c) enunciated in *Deakman-Wells Co.* v. *Commissioner* (C. A. 3rd, 1954), 213 F. 2d 894, an "adequacy of disclosure" case.

Section 6501(e)(1)(A) contains additional language, and to that extent changes were made. The substantive language was re-enacted, however, and the changes were purely to approve, explain, clarify and clearly adopt the proper construction of the predecessor statute. Cf. *Davis* v. *Hightower* (C. A. 5th, 1956), 230 F. 2d 549.

C. *The Decided Cases* (Resp. Br., pp. 24-33):

In the concluding section of his brief respondent apparently attempts to convey the impression that all of the courts prior to *Uptegrove* focused attention primarily upon the term "gross income" in the statute, and as a result thereof, concluded that all understatements of gross income were automatically omissions from gross income within the meaning of Section 275(c).

Respondent reads too much from the cases.

Admittedly the Tax Court and the Court of Appeals for the Sixth Circuit have held that overstatements of cost of goods sold result in omissions from gross income. It is questionable, however, as to whether the courts based their decisions on the reasoning espoused by respondent in his brief herein (or in the reasoning respondent attributes to the courts in his brief). Certainly the cited decisions of the Courts of Appeal for the Fifth Circuit and Second Circuit did not employ such reasoning.

The cases of *Foster's Estate* v. *Commissioner* (C. A. 5th, 1942), 131 F. 2d 405 and *Ketcham* v. *Commissioner* (C. A. 2d, 1944), 142 F. 2d 996 are so called "adequacy of disclosure" cases. The issue presented was whether the taxpayer had sufficiently disclosed in his return items of alleged non-taxable receipts. In these early decisions, the courts felt that the Commissioner should not be required to search throughout a return for the disclosure of items of receipt. Accordingly, the courts held that unless the receipts were sufficiently disclosed in the gross income section of the return, the taxpayer "omitted" from gross income amounts properly includible therein. Such cases are clearly distinguishable from the facts in the instant case where the respondent urges that an error in the form of an overstated "offset" or "subtrahend" item is an omission from gross income.

The case of *O'Bryan* v. *Commissioner* (C. A. 9th, 1945), 148 F. 2d 456, also seems to be an "adequacy of disclosure" case. In a later decision the Ninth Circuit so held. *Slaff* v. *Commissioner* (C. A. 9th, 1955), 220 F. 2d 65.

The case of *Carew* v. *Commissioner* (C. A. 6th, 1954), 215 F. 2d 58, is not in point. Therein the taxpayer "left out" a receipt of capital gain in an amount clearly in excess of 25% of the gross income stated in the return. The Sixth Circuit itself found the case distinguishable from *Uptegrove Lumber Co., supra.*

CONCLUSION.

Petitioner submits that respondent's arguments are overly technical and fragile. To petitioner's knowledge, a major portion thereof has never been advanced heretofore by respondent in any court. Respondent has refused to meet the issue squarely, perhaps because of the logically reasoned cases exemplified by *Uptegrove Lumber Co., supra.*

For the foregoing reasons, and the reasons set forth by petitioner in its opening brief, it is respectfully submitted that the judgment of the Court of Appeals for the Sixth Circuit should be reversed.

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